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## Beyond Risk Profiling: Achieving better investment outcomes for consumers and industry

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# White Paper:

## Beyond Risk Profiling: Achieving better investment outcomes for consumers and industry







# Summary

In the wake of the Retail Distribution Review, there remain fundamental questions about how best to support consumers to make sound investment decisions, particularly those with modest amounts of money to invest, for whom a poor investment decision may have a disproportionate adverse impact. The advent of new pension freedoms from April 2015, which give people more choice and flexibility about how they use their retirement savings, adds further impetus to the issue. To help inform policy and practice on this important subject, in June 2015 we brought together consumer and industry experts to explore possible new approaches to improve risk profiling and investment decision-making.

The sale of personal investments in the UK is polarised. At one end of the spectrum, regulated financial advisers offer personal recommendations to relatively wealthy consumers (typically with six-digit wealth) who are willing and able to pay for this specialist service. At the other end, consumers with modest sums of money face buying investments on an execution-only basis, with no personal recommendation from a professional adviser, and free to choose whether or not to use the information and guidance provided by firms and other bodies. There has been relatively little development in the middle ground, prompting a Financial Advice Market Review.<sup>1</sup>

Our Expert Workshop focused mainly on this middle ground between full regulated advice and execution-only sales. Ultimately, the real challenge is to design cost-effective solutions with a simple enough interface to engage people new to investing while also helping them think about the trade-offs and compromises that investing typically involves – and at the same time taking into account our natural inclination towards intuitive, fast and automatic decision-making.

From the Expert Workshop discussions, we have distilled four design principles to help improve risk profiling and investment decision-making:

**Design principle 1:** Strike a better balance between ‘downside’ and ‘upside’ risk in personal investing. For example, why not talk about ‘Your Investment Profile’ rather than ‘Attitude to Risk’?

**Design principle 2:** Attitude to Risk should refine, not define, investment decisions. Rather than start with someone’s risk profile, the Expert Workshop favoured a more goal-oriented approach, so that investment options are refined by a consumer’s risk preferences, rather than defined by them.

**Design principle 3:** Risk profiling represents a valuable learning opportunity, to fill in basic gaps in people’s understanding, and for consumers to learn something about their own emotions and behavioural biases when it comes to investing.

**Design principle 4:** Start simply and make it easy. The more effort it takes to invest, the more likely it is to put people off – especially those new to investing. It is therefore crucial to start simply and make it easy when it comes to investing. This means keeping things as simple as possible in terms of the data that consumers are asked to input, and making sure that the outputs generated from their data are easy to understand.

True Potential PUFIn plans to explore further some of the ideas raised in this White Paper through an investment decision-making simulation platform, configured as an investment game. The value of a simulation platform is that we can examine investment decision-making and risk profiling under real-life conditions, and test ways to improve people’s investment decisions that may be transferable to industry.



## Background

Our previous research White Paper, 'Towards a common understanding of risk', exposed the great variety of factors that affect people's perceptions of risk and their investment decisions. In full regulated financial advice, some or all of these factors may be taken into account in the face-to-face discussion between adviser and client, often with the help of risk profiling. This becomes more challenging in automated advice, and even more so when people elect to make their own investment decisions with no professional advice at all.

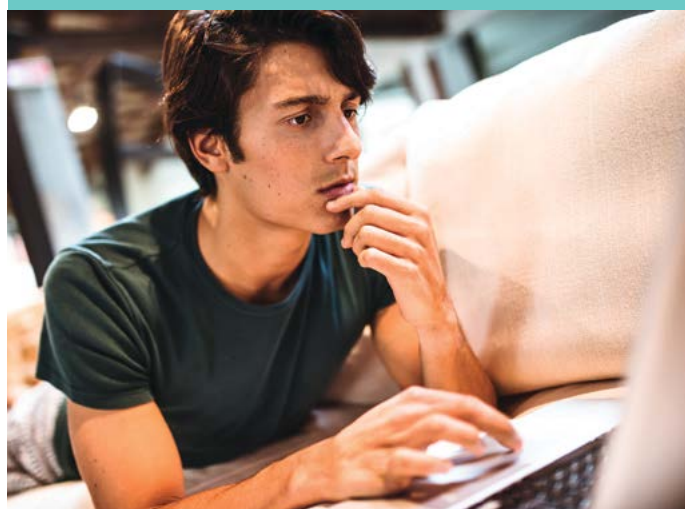
Given the great interest in this subject, we built on our prior research by convening an Expert Workshop in June 2015 to explore possible new approaches to improve risk profiling and investment decision-making. In particular, we wanted to consider the potential benefits of moving away from the idea of risk profiling as a process that reveals an investor's innate risk and return preferences, and moving instead towards a process which supports investors in constructing appropriate risk preferences through a learning journey that takes into account their goals, circumstances etc. Some firms are already moving in this direction.

To provide a balance of perspectives, the Expert Workshop comprised consumer and industry representatives with in-depth knowledge and experience of retail investing, financial advice, consumer behaviour and consumer protection. The Expert Workshop was held under the Chatham House Rule, whereby participants are free to use the information received, but neither the identity nor the affiliation of speakers may be revealed.

The aim of the Expert Workshop was to inform a set of principles and proposals to improve current approaches to risk profiling and investment decision-making. The workshop comprised small group discussions and feedback around six provisional propositions (see Appendix) that were informed by our earlier research on people's understanding of risk in relation to saving and investing.<sup>2</sup> While there was a good deal of consensus among the workshop participants, there were naturally also differences of opinion. This White Paper describes our interpretation and synthesis of the Expert Workshop discussions.

### What is risk profiling?

Risk profiling is used by financial firms to assess attitude to risk, mainly as part of an advisory process. The Attitude to Risk Questionnaire is the customer-facing part of risk profiling – a set of questions which is administered to the client using pen-and-paper or online. Behind the scenes, algorithms are used to score the client's answers to the questionnaire and to provide a risk profile for the client that can be used to help select an appropriate saving or investment product or products.



<sup>2</sup> <http://tinyurl.com/nk8exyc>

# The basic ingredients for informed investment decisions

The Expert Workshop discussed a range of ‘basic ingredients’ that, in an ideal world, help consumers to make informed investment decisions. These ingredients include:

- The consumer’s personal circumstances
- An investment goal, such as buying a home or building a fund for the future
- An idea of their investment time horizon
- How much they plan to invest, as a lump sum and/or on a regular basis
- Their attitude to risk and return, and
- Their ability to absorb falls in the value of their investments (known as ‘capacity for loss’).

In deciding what is the ‘right’ investment for them, consumers may have to make trade-offs between these and other factors; and they may make different trade-offs at different times in their lives. These trade-offs can be difficult, nuanced and emotive. We know, for example, that many UK consumers are risk averse when it comes to saving and investing. So if they choose the level of investment risk and return they are most comfortable with, they might not meet their longer-term investment goals. On the flipside, if they ignore their risk preferences they might lack the emotional resilience to weather the ups and downs of volatile assets or become unhappy with worry. Thinking through these trade-offs to arrive at an acceptable compromise are part and parcel of good financial advice.

Other factors that can influence personal investment decisions range from general decision-making capability, through to confidence and motivation, how someone feels about the prospect of investing (bored, excited, anxious), and the time and effort they are willing or able to give to making a decision. As the psychologist Daniel Kahneman has shown, a great deal of human decision-making is intuitive, fast and automatic,<sup>3</sup> which means that we often use shortcuts to come to a quick decision. Even when we take the time to think through an issue or problem in a deliberate, logical way, our emotions and natural biases (such as over-confidence, under-estimating the chance of negative consequences) can result in us coming to a less-than-optimal decision.

# Back to basics: What’s the purpose of risk profiling?

As described above, attitude to risk and return was identified in the Expert Workshop as one of the basic ingredients of personal investment decision-making. Risk profiling is used by financial firms to assess a consumer’s attitude to risk (and also their capacity to bear investment losses), mainly as part of an advisory process. Its purpose is three-fold: firstly, to help work out the ‘right’ investment for someone; secondly to help inform other financial decisions e.g. related to someone’s investment portfolio, tax planning etc.; and thirdly to help demonstrate to the regulator that an adviser has considered the client’s attitude to risk in an appropriate way.

The Attitude to Risk Questionnaire is the customer-facing part of risk profiling – a set of questions which is administered to the client using pen-and-paper or online. Behind the scenes, algorithms are used to score the client’s answers to the questionnaire and to provide a risk profile for the client that can be used to help select an appropriate saving or investment product or products.

Attitude to Risk Questionnaires are evolving, as we understand more about the shortcomings of human decision-making and our natural behavioural biases. For example, there is growing interest in the application of psychometric assessments, to better understand the personality traits (such as emotional stability, conscientiousness) that are likely to shape a client’s responses. Our previous research showed the potential value of tailoring Attitude to Risk Questionnaires to people’s circumstances, for example to focus on specific investment goals or time horizons.

In the opinion of the Expert Workshop, risk profiling is a valuable part of personal investment decision-making – and not only for consumers who receive some form of regulated advice. In non-advised sales as well, that do not involve a personal recommendation, consumers should be encouraged to think about their own attitude to risk (a view shared by the regulator<sup>4</sup>), alongside other basic ingredients such as investment goals, personal circumstances, time horizons, and capacity for loss.

<sup>3</sup> D. Kahneman 2012. *Thinking, Fast and Slow*. Penguin Books.

<sup>4</sup> FG15/1: *Retail investment advice: Clarifying the boundaries and exploring the barriers to market development*. Financial Conduct Authority, January 2015. Page 25, paragraph 3.56. <http://tinyurl.com/kxfvy2y>



# Beyond risk profiling: Four design principles to aid personal investment decision-making



Psychometric testing and behavioural biases were among the themes discussed in the Expert Workshop, along with other issues such as the costs of investments and the impact of regulation.

To stimulate ideas and fresh thinking about risk profiling and personal investment decision-making, the Expert Workshop first of all undertook 'divergent thinking'. This is a method of generating creative ideas by exploring many possible solutions, where thinking should be unconstrained by existing processes and structures – such as regulation.

From the ideas generated by the industry and consumer experts who attended the workshop, we have distilled four design principles to help improve approaches to risk profiling and personal investment decision-making. How these principles might be put into practice depends on the regulatory framework governing personal investment, which we consider later on.

## Design principle 1: Strike a better balance between 'downside' and 'upside' risk

From behavioural economics, we know that how information is presented and framed can impact significantly on people's behaviour. In the Expert Workshop, there were concerns that risk profiling in personal investment tends to emphasise 'downside' risk (the financial risk associated with losses) at the expense of 'upside' risk (the uncertain possibility of gain).

As a result, consumers may be overly risk averse (bearing in mind that UK consumers are already inclined to be cautious) and possibly invest less than they would otherwise. In other words, risk profiling may reinforce reckless conservatism (the reluctance to take investment risk which in turn may jeopardise longer-term objectives)<sup>5</sup> rather than challenge it.

**“One of the biggest issues with the risk questionnaires now is because of all the things we have to put in there about loss aversion and capacity for loss, it's all loss, loss, loss. So when you look at the behavioural aspect clients are going in with the mind-set of I'm going to lose my money.”**

(Expert Workshop participant)

While conscious of consumer protection, Expert Workshop participants suggested some simple ways to strike a better balance between 'downside' and 'upside' risk in personal investment terminology, such as talking about 'Your Investment Profile' or 'Your Investment Personality' rather than their 'Attitude to Risk', or referring to 'investment expectations' instead of risk and return.

<sup>5</sup> *How do savers think about and respond to risk? Evidence from a population survey and lessons for the investment industry. Pensions Institute, Cass Business School, 2014*

## Design principle 2: Attitude to Risk should refine, not define, investment decisions

Across all the small group discussions that took place at the Expert Workshop, one hotly debated topic concerned the point at which someone's attitude to risk should be taken into account in personal investment decision-making, as well as the extent to which it should be taken into account.

The general view was that asking consumers to consider their attitude to risk at the very start of their personal investment 'journey' risked placing undue weight on their risk preferences relative to other factors. In the context of financial advice, workshop participants feared that investment recommendations could be 'engineered' to fit the consumer's attitude to risk, which may not result in the best outcome.

**"The thing I think is dangerous is to give the risk profiling too much force and then say okay this is the person's attitude to risk, therefore I must design the whole solution around that. It might not have been the best solution for them, it might just be a behavioural bias which you then need to discuss with them."**

(Expert Workshop participant)

A better approach, it was felt, is to first help consumers establish whether investing is a sensible option for them, and then make their investment goal the starting point (as some firms and financial advisers do already), and work from there. Equally, there could be advantages to assessing attitude to risk right at the end of the decision-making process, so that investment options are refined by attitude to risk, rather than being defined by it. Considering attitude to risk later in the process may also help guard against reckless conservatism.

This shift from person-oriented risk profiling towards more goal-oriented risk profiling also fits with the idea that people may have (indeed should have) different risk preferences depending on their goals, circumstances, time horizons and the money they can afford to invest. For example, it makes good sense for a consumer in their 20s to invest their long-term pension savings in higher-risk investments; whereas there is a case for the same consumer to invest in less risky assets to achieve shorter-term goals such as buying a car. In fact, the Expert Workshop felt that both are required: a goal-oriented element for specific investment decisions, and a person-oriented element to help someone understand their risk preferences in relation to their overall investment portfolio.

In keeping with the idea that risk preferences should refine rather than define investment decisions, there was a suggestion that the traditional Attitude to Risk questionnaire be deconstructed and the questions embedded throughout the wider decision-making process, rather than grouped together survey-style. Where investment decisions are made with the help of a personal recommendation, this could bring tensions with regulation if it proved less straightforward to assess whether or not the recommendation was suitable.

## Design principle 3: Risk profiling represents a learning opportunity

In our previous research White Paper, 'Towards a common understanding of risk'<sup>6</sup>, we reported concerns (particularly among financial advisers who deal with consumers on a day-to-day basis) that UK adults do not always have a good grasp of fundamental concepts such as inflation, tax, probabilities, how financial markets work and how these concepts relate to someone's own investments. That research also confirmed there to be a significant difference between the investment industry's actuarial understanding of risk and the ways in which ordinary investors think about and engage with risk.

Consumer education was a theme that the Expert Workshop kept coming back to. There was a strong sense that risk profiling (and personal investment decision-making more generally) offer two types of learning opportunity.

First, there is an opportunity to fill in some of the fundamental gaps in consumers' understanding of personal investment and the type of investment that might be right for them, including their risk and return preferences.

**"It's a process by which the client might incrementally acquire skills and understanding around risk that means that they can make more and more steps towards being able to make decisions independently."**

(Expert Workshop participant)

One crucial aspect here is for consumers to appreciate the different costs of personal investing, and to consider the likely impact of fees and charges on their investment returns. Working out the true costs of investing is not straightforward for consumers, however, because many of the charges are deducted directly from the fund and remain hidden. This has led to calls for more cost transparency, such as a single charge.<sup>7</sup>

<sup>7</sup> Financial Services Consumer Panel, November 2014, *Investment costs – more than meets the eye*

<sup>6</sup> <http://tinyurl.com/nk8exyc>

**“... it’s helpful for people to understand how everybody else is making money, so where do these fees go and how are they charged, who do they go to and what do they go to for... it’s understanding a little bit about why you’re paying something when you’re paying it and how often you’re going to pay it, that is quite important.”**

(Expert Workshop participant)





Secondly, there is an opportunity for consumers to learn something about themselves, for example about their behavioural biases and their likely emotional responses along the ups and downs of an investment journey. Armed with the knowledge that ‘markets always wobble’, greater self-awareness and an appreciation of emotional resilience may help someone avoid the common mistake of selling following price falls and buying following price rises.

While the Expert Workshop saw plenty of scope for learning opportunities, it also recognised that industry enthusiasm for consumer education is not shared by all consumers. Our natural tendency towards ‘fast thinking’ means we may not be willing or able to expend a lot of time and effort learning about personal investing, even if we know it might mean a better result in the long run. For this reason, there was some support in the Expert Workshop for ‘smart defaults’ beyond their current use in personal pensions, in situations where personal investment made sense. Other participants were uneasy about the likely suitability of ‘default’ personal investments, however.

**“If you know nothing you should go the smart default, you should go with passive instruments looking out for the fees, you should go for moderate risk, you should have an emergency savings fund alongside your investments so that you have a safer environment to invest, in case you need cash when the market goes down.”**

(Expert Workshop participant)

## Design principle 4: Start simply and make it easy

Retail investment is a complex market. Realistically, the mental effort that an average consumer is prepared to give to personal investing is likely to be relatively low – and almost certainly much lower than the industry imagines. Coupled with this, cognitive psychology shows that heavy cognitive load (the total amount of mental effort being used in the working memory) can have negative effects on the likelihood of completing a task, such as taking out an investment.<sup>8</sup> Efforts to make it easier for retail investors to navigate the market include the implementation of a Key Information Document that provides clear and comparable information in the same way for all packaged retail investment and insurance products.<sup>9</sup>

With this in mind, the Expert Workshop was in agreement that, whatever learning opportunities might be available, someone’s investment journey should ‘start simply’ and be made easy – especially if they are new to investing. This means keeping things as simple as possible in terms of the data that consumers are asked to input, and making sure that the outputs generated from their data are easy to understand.

**“There are those who have a very low threshold who if they get asked very many questions they’re going to switch off and not do anything.”**

(Expert Workshop participant)

At the same time, the Expert Workshop was keen to see the idea of a ‘safety gate’ built in to the process, something they felt is lacking in automated tools at the moment. This would ensure that consumers ‘do not pass go’ if the data they input indicate that personal investing is not a sensible option for them, for example because they should consider repaying outstanding debts first, or because they have little or no liquid savings.

Even if they ‘start simply’, consumers should still be in a position to make a decision when presented with their outputs, for example to take out an investment, to seek advice or to do some more research. For consumers who want more detail, there can be ‘add-ons’ that expand the options open to them or provide more in-depth insights.

<sup>8</sup> See for example Kahneman, D. (1973). *Attention and Effort*. New Jersey: Prentice-Hall.

<sup>9</sup> ‘The right investment to suit your needs: basic information document will help retail investors make the right choice’. European Commission Statement/14/122, 15 April 2014



## From principles to practice

The Expert Workshop's 'divergent thinking' generated creative ideas that we distilled into a set of design principles, as described previously. These are intended to apply to any personal investment decision-making, whether or not it involves a personal recommendation from a regulated financial adviser.

The Expert Workshop was subsequently asked to think about concrete ways to put their ideas into practice, based on the idea of 'convergent thinking' - a type of thinking that takes into account limiting or constraining factors. Part of this process involved narrowing the focus to a target group of consumers. In all cases, the Expert Workshop participants chose to focus on consumers with relatively modest amounts of money to invest (typically between £5,000 and £10,000), who are likely to make decisions without professional advice, or at most to engage in a simple or automated advice process if it were available.

Not surprisingly, technology-enabled solutions were very much to the fore in the Expert Workshop's thinking about putting ideas into practice, as was regulation. A final piece in the jigsaw was how to help investors match their 'investment profile' to suitable investment products.

### Regulation

The sale of personal investments in the UK is polarised. At one end of the spectrum, regulated financial advisers offer full financial advice with personal recommendations to relatively wealthy consumers (typically with six-digit wealth) who are willing and able to pay for this specialist service. At the other end, consumers with relatively modest sums of money, who cannot afford or do not want

to pay for advice, face buying investments on an execution-only basis, with no personal recommendation from a professional adviser, and free to choose whether or not to use the information and guidance provided by firms and other bodies.

To date, there has been little development in the middle ground between full regulated advice and execution-only sales. Simplified ways of recommending retail investments to people with modest wealth have so far not got off the ground. And while many firms offer technology-enabled services to help people choose retail investments that stop short of making a personal recommendation, there was a general view in the Expert Workshop that greater innovation has been hampered by firms' concerns about overstepping the regulatory boundary.

**"The problem we have in the UK is the definition of advice is so broad that it's very difficult to talk to a client without giving advice. So the Regulator is unintentionally making it very difficult for firms to develop all the kinds of things we've been talking about."**

(Expert Workshop participant)

Indeed, the Expert Workshop was conscious that some of its proposals, such as video case studies that help people narrow down their choice of investments and colour coded risk labelling (see below), might well constitute a personal recommendation under FCA Guidance.<sup>10</sup> In principle, there is nothing in the regulatory regime to prevent firms and advisers offering personal recommendations through an automated advice process. In practice, the challenge for firms is how to deliver these services on a commercial basis given the costs involved in any form of regulated advice, particularly when the target audience is consumers with modest amounts of wealth and fairly straightforward investment needs, who may not be prepared to pay much (if anything) for a completely online service. Several (but not all) workshop participants felt that it may be impractical to bring some of these ideas to fruition without a relaxation of regulation.

**“You should be able to have rules of thumb and you should be able to say ‘people like you did this’, without that constituting advice.”**

(Expert Workshop participant)

These and other issues related to the ‘advice gap’ are the subject of a Financial Advice Market Review, co-chaired by HM Treasury and the FCA.<sup>11</sup>

## Technology-enabled solutions

Technology plays an increasing role in the UK’s everyday life, with smartphones the most popular device for getting online, owned by 66 per cent of UK adults (up from 39 per cent in 2012).<sup>13</sup> The Expert Workshop felt that, while firms and advisers make growing use of technology, its potential to help consumers navigate their personal investment journey has yet to be fully realised.

At the heart of the Expert Workshop’s discussions on technology-enabled solutions was the concept of intelligent interaction, whereby the personal data input by a consumer is used to shape their investment journey in a way that makes sense to them, and creates a strong image of what it might look like using data visualisation techniques. Intelligent interaction could, for example, help consumers set an investment goal; explore the different trade-offs they might make; visualise what different investment outcomes might look like, and how they might feel about those outcomes. To work for consumers, intelligent interaction has to stay faithful to the principle of ‘start simply and make it easy’, while also building in additional information and guidance for those who want it – reflecting the idea of personal investing as a learning journey.

While intelligent interaction is already used in these ways by some firms, the Expert Workshop saw greater scope to incorporate things like video case studies to provide real-life examples of personal investment journeys and make the ‘scarily unfamiliar’ more familiar; and interactive simulations of different investment outcomes to see how consumers might respond to the ups and downs of investing.

**“... case studies and videos, much more engaging, real life, norms, all those kinds of things coming in, which is very different from a ‘tick the questions’ kind of risk profiler.”**

(Expert Workshop participant)

As the aggregation of personal finance data becomes more common, the concept of people having a personalised ‘money profile’ that brings together all their financial information (including their investments) also becomes plausible. Link this to machine learning and artificial intelligence, and opportunities open up to create intelligent ‘goal trackers’ that could, for example, send automatic alerts when someone’s spending patterns threaten to derail their personal investment goals.

The Expert Workshop also viewed intelligent interaction as the means to build in to the decision-making process the ‘safety gate’ described earlier, to ensure that consumers ‘do not pass go’ if the data they input indicate that personal investing is not a sensible option for them.

Bringing together the Expert Workshop’s discussions, we propose a conceptual model for technology-supported personal investment decisions (Figure 1). This is not intended to comprehensively map what a personal investment journey might look like, rather it is intended to capture some of the common elements that the Expert Workshop agreed were important and which could be made possible with intelligent interaction such as building in a ‘safety gate’ to make sure investing is a sensible option; creating learning opportunities at key points; and having ‘emotional checkpoints’ and validation points.

<sup>10</sup> FG15/1: Retail investment advice: Clarifying the boundaries and exploring the barriers to market development. Financial Conduct Authority, January 2015. <http://tinyurl.com/kxfvy2y>

<sup>11</sup> [www.gov.uk/government/publications/financial-advice-market-review-terms-of-reference/financial-advice-market-review-terms-of-reference](http://www.gov.uk/government/publications/financial-advice-market-review-terms-of-reference/financial-advice-market-review-terms-of-reference)

<sup>13</sup> *The Communications Market 2015 (August)*, Ofcom. <http://tinyurl.com/qd7wm85>



Figure 1: A conceptual model for technology-enabled retail investment decisions



# A better system to match ‘investment profile’ to suitable investment products

The Expert Workshop felt that consumers who buy retail investments without a personal recommendation would benefit from some better system of labelling on investment products, to help them align their investment choices with their own risk and return preferences. Such a system should be easy to understand; the information should be prominently displayed in fund factsheets and other documents; and consumers should be able to search for funds online using the risk and return ratings.

**“You figure out what risk you want and then you have a way of figuring out how to buy it.”**

(Expert Workshop participant)

**“... in the non-advice space the risks should be flashing, this is what you’re buying, this should be like slapping people in the face, not buried ... you tick the box and say that you’ve read it before you can buy it.”**

(Expert Workshop participant)

A real challenge here is devising a system that bridges the gap between the objective measures of risk and return used by regulators and the industry, and consumers’ own subjective attitudes towards risk and return.

There exists already a standardised risk rating for all funds, called the Synthetic Risk and Reward Indicator (SRRI), which is on a scale of 1 to 7, based on the volatility of fund returns over the previous five years.<sup>13</sup> Designed to help consumers choose between investment funds, the SRRI must be included in the Key Investor Information Document that consumers receive when they are buying an investment.

As far as consumers are concerned, workshop participants felt the SRRI was not really up to the job. The SRRI has been criticised because a significant proportion of funds falls into a small number of categories (called ‘bunching’) which makes it hard for consumers to differentiate between different funds; and the value of past volatility in fund returns as a guide to future performance has been questioned.<sup>14</sup> Workshop participants made the point that there is currently no easy way for consumers to search for funds online by SRRI (or some other score or rating); requiring fund platforms to have searchable risk and return ratings was suggested as one way to overcome this. In any case consumers may find it difficult to match their own subjective risk and return preferences to an objective scale that runs from 1 to 7.

In addition to the mandatory SRRI, fund managers, firms and ‘infomediaries’ (such as FE TrustNet and Morningstar) can produce their own objective risk and return ratings for funds, based on fund volatility and other capital market metrics. In an advisory process, these labels are designed to make it easier to match an individual’s risk and return preferences to an appropriate product. For example, as reported in our previous White Paper, Morningstar’s five risk profiles are Defensive, Cautious, Balanced, Growth, and Aggressive. The ATR Questionnaire produces five similarly-labelled risk profiles: Cautious, Moderately Cautious, Balanced, Moderately Adventurous, Adventurous.<sup>15</sup> Firms are free to create their own rating systems, which means that labels like ‘balanced’ and ‘cautious’ may mean different things across different products and providers – and equally, similar funds may be labelled differently.

To make it more straightforward for consumers to compare the risk and return ratings of funds (and to relate that information to their own investment profile), one proposal from the Expert Workshop was for a standard industry-wide system of risk and return ratings or labels, based on a fund’s asset allocation. In other words, any fund labelled ‘Growth’ would comprise a broadly similar mix of assets (even though the underlying investments would be different). Similarly, in our previous research study, ‘Towards a common understanding of risk’<sup>16</sup>, one of the stakeholders we interviewed suggested creating a ‘loss rating’ system for funds, that would be produced by fund managers using a standard formula, to help like-for-like comparison by consumers and advisers. Whatever shape it took, the Expert Workshop participants saw a role for the regulator in facilitating the development of any such industry-wide system of risk and return ratings.

<sup>13</sup> CESR’s guidelines on the methodology for the calculation of the synthetic risk and reward indicator in the Key Investor Information Document. Committee of European Securities Regulators, July 2010, CESR/10-673

<sup>14</sup> ‘How risky is your fund? Two out of five sold in the UK are given a high risk rating due to volatility levels’ Tanya Jefferies, 13/11/14, Mail Online. <http://tinyurl.com/q47csx4>; Note on CESR’s recommendations for the calculation of a synthetic risk reward indicator. Association of British Insurers/Investment Management Association Research Brief, March 2010. <http://tinyurl.com/qyj9qbl>

<sup>15</sup> <http://tinyurl.com/nk8exyc>

<sup>16</sup> <http://tinyurl.com/nk8exyc>

Such a system of standard risk and return metrics could even be colour-coded to help consumers match their investment profile with appropriate investment funds or check their investment profile against their portfolio.

**... just make a list of all the investments you've got and then the machine will look at all those investments and tell you that this one is pink, this one is red, this one is green and this one is bright green, overall your portfolio is kind of yellow. When we say it's yellow what we mean is this, red would be high risk of losing money in the short term, yellow would be more stable returns... if you do your own risk profile and you come out as mauve, you then analyse the risk in your portfolio and say oh the portfolio is red but you're mauve, now this is what that mismatch means.**

(Expert Workshop participant)

This type of simple visualisation to match a consumer's risk profile with appropriate investments would probably constitute a personal recommendation under the FCA's guidance.<sup>17</sup> Its value would be as part of a simplified automated advice process, therefore, rather than for consumers who buy investments on an execution-only basis.



<sup>17</sup> FG15/1: Retail investment advice: Clarifying the boundaries and exploring the barriers to market development. Financial Conduct Authority, January 2015. <http://tinyurl.com/kxfvy2y>



# Final thoughts

The Expert Workshop brought together consumer and industry representatives with a wealth of expertise and knowledge about retail investing, financial advice, consumer behaviour and consumer protection. The lively discussions highlighted a common interest in helping consumers get more out of retail investing – even if they only have modest sums to invest; while also recognising the difficulties that ordinary consumers face navigating such a complex market.

The Expert Workshop reinforced the idea of moving away from risk profiling as a process that reveals an investor's innate risk and return preferences, towards a process which supports investors in constructing appropriate risk preferences through a learning journey. There was also a shared view that the potential for technology-enabled services to help consumers navigate their personal investment journey has yet to be fully realised. The Financial Advice Market Review provides a great opportunity to think about putting some of these ideas into practice. Technology may also support a move towards simplification of investment products in the interests of consumers.

Ultimately, the real challenge is to design cost-effective solutions with a simple enough interface to engage people new to investing while also helping them think about the trade-offs and compromises that investing typically involves – and at the same time taking into account our natural inclination towards fast, intuitive and automatic thinking even for crucial decisions such as saving and investing.

As part of our programme to improve people's understanding of personal finance, True Potential PUFIn plans to explore some of these issues through an investment decision-making simulation platform, configured as an investment game. The value of a simulation platform is that we can examine investment decision-making and risk profiling under real-life conditions, and test ways to improve people's investment decisions that may be transferable to industry.

# Appendix

The Expert Workshop was convened in central London in June 2015. It was facilitated by Mark Fenton-O'Creevy, Professor of Organisational Psychology at the Open University Business School and member of True Potential PUFIn. Other members and Associates of True Potential PUFIn acted as rapporteurs: Will Brambley (Research Associate), Sharon Collard (Professor of Personal Finance Capability) and Jonquil Lowe (Lecturer in Personal Finance).

We are very grateful to the following people who committed their time to participate in the Expert Workshop:

Ylva Baeckstrom	Cass Business School
Leigh-Anne Basaraba	True Potential LLP
Katie Ellis	True Potential LLP
Anastasia Georgiou	Morningstar
Mike Gould	The Investment Association
Emily Haisley	Barclays
Nick Hill	Money Advice Service
Hans Hoggerman	Barclays
Emma Napier	True Potential LLP
Roderic Rennison	Rennison Consulting
Faith Reynolds	Financial Services Consumer Panel
Janette Weir	Ignition House

Their participation should not be taken to imply agreement with the content of this White Paper, which represents the views of the authors based on their interpretation and synthesis of the workshop discussions.

The workshop comprised small group discussions focused around six provisional propositions, outlined in the PowerPoint presentation below. In the morning session, participants were asked to consider these propositions using 'divergent thinking', which is a method of generating creative ideas by exploring many possible solutions, where thinking should be unconstrained by existing processes and structures – such as regulation. In the afternoon session, participants were asked to think about concrete ways to put their ideas into practice, based on the idea of 'convergent thinking' – a type of thinking that takes into account limiting or constraining factors.



## Improving the risk profiling process: Achieving better outcomes for consumers and the industry

Some propositions



## Plan for the day

- Some provisional propositions arising from our research
- Divergent thinking in small groups – implications for what we might do about risk profiling
- Convergent thinking in small groups – principles and proposals for new/modified approaches to risk profiling
- We capture the discussions and your conclusions
- We write up a set of principles and proposals for risk profiling design and circulate for your comment.



## Six propositions about risk profiling

1. There are problems with existing risk profiling approaches
2. People do not have risk preferences ready waiting to be revealed but construct those risk preferences in the process of engaging with specific goals and challenges
3. A common cause of underperformance is the behavioural risk associated with lacking the emotional resilience to stick to an investment strategy and ride out market volatility
4. A second common cause of underperformance can be the risk that fee structures significantly erode returns and many clients may fail to understand this risk
5. There is a significant difference between the industry actuarial approach to understanding risk and the ways in which ordinary people engage with risk
6. Different people may need different approaches

#### SLIDE 4



## There are problems with existing risk profiling approaches

- At their best existing tools are an enabling device which support a structured conversation with advised clients and support a learning process
- Too often they are either a tick box approach which do no more than provide a compliance audit trail or treated as a black box which will provide 'the answer' to the appropriate investment strategy
- Clients often find the questions too abstract and hard to relate to
- The same tool often gets used regardless of the client's circumstances or objectives
- Regulators, industry and consumer groups all have concerns about current approaches (albeit sometimes different concerns)

#### SLIDE 5



## People do not have risk preferences ready waiting to be revealed but construct those risk preferences in the process of engaging with specific goals and challenges

- Implies seeing risk profiling as a process of supporting a client's construction of their preferences
- May imply that risk profiling is often a learning process

#### SLIDE 6



## Behavioural risk /emotional resilience

- 20 years of data (Dalbar) on investor behaviour in 401k plans
- Shows investor returns to consistently underperform the assets they invest in.
- It is largely due to investors mistiming the market, selling following price falls and buying following price rises
- Most risk profiling approaches ignore this risk (at least one honourable exception)



## Transparency of fee structures

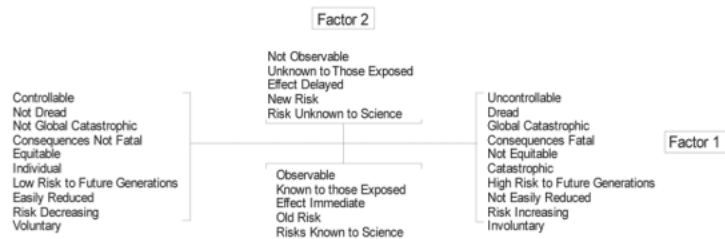
- A work in progress?
- Issues with client understanding

Significant difference between the industry actuarial approach to understanding risk and the ways in which ordinary people engage with risk

## Slovic's studies – risk as feelings



## SLIDE 10



## SLIDE 11

### Different people may need different approaches

- Delegators vs Affirmation Seekers vs DIYers
- Life stage differences
- Levels of understanding and confidence (which may be loosely coupled)

# About True Potential PUFin

The True Potential Centre for the Public Understanding of Finance (True Potential PUFin) is based at the Open University Business School (OUBS). True Potential PUFin is a pioneering centre of excellence for research and teaching related to personal finance capability. It brings together academics with expertise in fields such as regulation, taxation, consumer attitudes, motivations and behaviours, and social marketing.

The establishment and activities of True Potential PUFin have been made possible thanks to the generous support of True Potential LLP. True Potential LLP has committed to a five-year programme of financial support for the Centre. Views expressed by True Potential PUFin are those of the academics involved and do not necessarily reflect those of True Potential LLP.

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This White Paper was authored by Sharon Collard (Professor of Personal Finance Capability), with Will Brambley (Research Associate) and Jonquil Lowe (Lecturer in Personal Finance)

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The True Potential Centre for the  
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of Finance





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